Issue number 7

ITEM Club

Spring 2013

# Ernst & Young ITEM Club

## Outlook for financial services

### Ernst & Young ITEM Club

The ITEM club outlook for financial services examines the implications of ITEM Club's economic projections for the financial services sector.

Ernst & Young is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

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### Introduction

Since our last report in early February there has been little change to the level of the UK equity market. Equity volatility has been relatively low despite the bailout of the Cypriot banking system, an inconclusive Italian election, and the US failing to agree on a plan to avert the fiscal tightening initiated by its 'sequester'. If any of these events had happened last year when investors were more nervous about the resolve of policy makers and the durability of the recovery in the global economy, the market reaction would undoubtedly have been more severe. We view this as further evidence that the risk environment is starting to return to more normal conditions. We continue to believe that this normalisation process will reduce investors' focus on 'safe-havens', such as gilts and gold, and increase the pace of growth of business investment.

The major European markets are still in recession and business confidence is taking time to recover from the trials and tribulations of the past few years. This leaves the UK economy heavily dependent on the home market this year, with GDP expected to grow by just 0.6%. Nevertheless we are more optimistic about longer-term prospects as world trade picks up due to stronger growth in the US and emerging markets, and as UK business spending recovers, helping UK output to grow by 1.9% in 2014 and 2.5% in 2015.

The rebalancing of the economy is effectively on hold until global markets improve, but fortunately households are now in a position to provide some much-needed momentum. Real incomes are growing again, helped by the strength of employment, while the high savings ratio has facilitated balance sheet repair. Household spending added 0.7% to GDP last year, helping the economy to grow by 0.3% even though net trade reduced GDP by 0.9%. Employment growth is set to fall from 600,000 to 250,000 this year, but the increase in personal allowances this April and next will help maintain the growth in real disposable incomes and consumption.

Nevertheless, the all-important mortgage and housing markets have remained in the doldrums, held back by risk-averse lenders and a lack of capital that are preventing households from moving. Transactions picked up in the second half of last year, but remain well below the levels seen in a properly functioning housing market. Housing investment has dropped to an unsustainable level.

The government is trying to improve the situation with the 'Help to Buy' proposals in the budget, which should support some potential buyers who have insufficient capital. We expect a million households to move this year, improving labour mobility. The increase in housing market transactions will in turn boost sales of household appliances and other goods purchased when moving home. Given planning constraints, the impacts on house-building and prices are harder to predict, but are likely to be significant in 2014 and 2015.

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The budget has raised hopes of moving to a more active monetary policy when the new Governor of the Bank of England arrives this summer. Forward guidance on interest rates will be hard to specify with inflation remaining stubbornly above target. With interest rates at rock bottom, quantitative easing (QE) is nearing its sell-by date, distorting financial markets and balance sheets without significantly affecting interest expectations or spending.

## Table 1: Forecasts of the UK economy

Annual percentage changes unless specified

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| GDP | 1.0 | 0.3 | 0.6 | 1.9 | 2.5 | 2.5 |
| Consumer prices | 4.5 | 2.8 | 2.8 | 2.6 | 2.6 | 2.5 |
| Average earnings | 2.7 | 1.5 | 1.8 | 3.2 | 4.2 | 4.7 |
| Unemployment rate (%) | 4.7 | 4.7 | 4.6 | 4.4 | 4.1 | 3.8 |
| Government net borrowing (% of GDP) | 7.9 | 6.5 | 6.5 | 6.0 | 5.1 | 3.6 |
| 3-month interbank rate rate (%) | 0.9 | 0.8 | 0.5 | 0.5 | 1.0 | 2.0 |
| Effective exchange rate | 80.0 | 83.1 | 80.1 | 79.3 | 78.5 | 77.7 |

Source: ITEM

# Executive summary

## Banking

- Although the banking sector is not yet in a position to contribute to economic growth, we expect it to act as much less of a brake on the UK economy in 2013 than in the past five years. From 2014 onwards, banks should be able to ease access to credit, thereby supporting an expansion in spending by both businesses and consumers.
- The 'Help to Buy' scheme that the Government announced in the March budget means we are increasingly confident in our forecast that growth in the stock of mortgages will gradually accelerate. We now forecast a 3% rise in mortgages this year, up from 2% in 2012, with a stronger pickup to follow between 2014 and 2016. Although it has had a limited effect so far, the recently announced extension of the Funding for Lending (FLS) scheme should also support this growth. With banks' business loan write-offs having peaked in mid-2012, and provisions against losses now falling, loans to businesses are forecast to rise by 3% in 2013, after four years of decline. Business loans are then forecast to pick up strongly from 2014 onwards as current concerns ease and economic activity picks up more noticeably, in turn boosting business investment.
- Banks in the UK will continue to face pressures to deleverage and cut costs. But the deleveraging process seems to be coming to an end. Encouragingly, total assets did not shrink as much as we had forecast during 2012. Banks' balance sheets are expected to rise by a moderate 1.7%, in 2013. Growth in total assets is then forecast to strengthen in subsequent years, picking up pace more significantly in 2015 and 2016 as economic growth accelerates and confidence returns.
- Total loans, which include loans between financial institutions, are expected to fall once again this year as proprietary trading activity continues to shrink. The banking sector will focus on traditional banking activities and rebuilding capital to counter any further potential shocks. Total lending is now not expected to return to its 2010 level until 2015.
- Despite some encouraging signs that credit quality is improving, banks' profitability will remain under pressure because very low interest rates are depressing margins, reducing their ability to lend to more profitable sectors and also weighing on economic growth. Total income at UK banks is expected to rise by 1.5% in 2013 after an estimated 2% decline in 2012, and then to recover more strongly as economic conditions gradually improve and interest rates stay low. Income is forecast to return to its 2010 peak by 2017.

## Insurance

- The slow overall recovery is creating challenges for the UK's life insurance businesses, which are also facing uncertainty over Solvency II requirements. We expect only moderate growth in premium income in 2013 and 2014. The introduction of the Retail Distribution Review (RDR) and a commission ban to reduce 'churn' is already reducing business. This effect, combined with a slowdown in the growth rates of employment and real income, will result in life premium growth remaining negative in real terms in 2013.
- Premium growth will pick up from 2015 to 2016, as the economy improves and housing market turnover rises. Nevertheless, premium income is expected to be 20% below its 2007 peak even by 2016. Critical illness and life insurance products will make even slower progress.
- Life insurers have been moving away from traditional guaranteed business in favour of protection and platforms. Nevertheless, they will need to continue to manage their legacy book of guaranteed business, which should improve as gilt yields rise. As challenging market conditions persist, life insurers have been forced to improve investment and asset/liability management, as well as reducing operational costs, improving underwriting, and adjusting policyholder bonuses and crediting rates. Some life insurers are also redesigning their business portfolios and undertaking structural changes. We expect more industry consolidation in 2013, given that insurers' profits declined for the second consecutive year in 2012.
- Moderate price increases and an improving economy will help non-life insurance premiums to continue their recovery with annual premium growth to average 4.3% between 2013 and 2016. We estimate that non-life insurance premiums grew by 3.1% in 2012. Given the weakness of the economy, most of this growth came from moderate price increases in some market segments, such as health, rather than exposure growth. We expect annual premium growth to improve, averaging 4.3% between 2013 and 2016.
- Prices have started to rise in some non-life insurance segments, including health insurance, but this trend is not widespread. We expect pricing to improve this year, especially in property, corporate and reinsurance, not least because below-cost pricing is unsustainable for any length of time. While Consumer Price Index data shows that private motor insurance prices increased in March, we believe that motor prices will continue to struggle. Many insurers have assumed optimistically that forthcoming legal and regulatory changes will reduce their costs, and are also vying to grow their market share. Their efforts to do this will drive competition and suppress price increases.

## Asset Management

- Investor behaviour should become more driven by fundamentals as the global risk environment returns to more normal conditions. Markets appear to be more robust to shocks than expected, having taken the Italian elections and the bailout of Cyprus in their stride.
- We expect assets under management (AUMs) to rise by 10% in 2013 and 7% in 2014. The strongest growth in AUM will be in 'risk assets' such as equity funds, high-yield debt, multi-asset funds and fund of funds, rather than in defensive asset classes such as government bonds, money market funds or commercial property. The only two fund types to see AUMs fall in 2012 were UK-focused property and hedge funds. This year fixed income funds saw their first outflows since October 2008.
- UK-focused funds saw their AUMs grow by 14% in 2012, in line with the forecast in our last report. The main drivers of this growth were equity and multi-asset funds, with the largest contribution to growth coming from equities. Multi-asset funds also performed very well for the fourth consecutive year, benefiting from demand from smaller pension funds outsourcing their asset allocation. If this sector continues to grow at its current pace, it will manage around a fifth of all UK-focused assets by 2016. Even if growth slows, as we expect, it will still be the second largest fund type after equities.
- We expect equity funds to be one of the main beneficiaries of risk normalisation, with growth of 10% in 2013 and a further 8% in 2014. Fund of funds, which have a high equity content, are likely to see double-digit AUM growth in 2013 and 2014.
- Reduced desire among investors for safe havens and the potential for negative returns are expected to result in a shift out of gilt-funds, with AUMs declining in 2015 and 2016. We believe that renewed investor confidence will also cause money market AUM growth to slow from 6% in 2012 to around 1% in 2013 and 2014.

# Banking

With domestic demand remaining subdued and external demand weak, the UK economy is expected to grow by only 0.6% in 2013, a pace that appears too slow to spur any revival in the banking sector. However, the banking sector is expected to act as much less of a brake on the economy than in the past five years. Based on the more encouraging economic forecasts from 2014 onwards, banks are expected to support stronger growth in both corporate and consumer spending as the economy in general also picks up pace. In the short term, banks may continue to face pressures to deleverage and cut costs, although the deleveraging process in the sector now seems to be easing. In addition, faced with rising regulatory costs that are negative for their businesses, banks are continuing to restructure, and are overhauling or selling off operations that have come under scrutiny over the past few years. However, more encouragingly, total assets fell by slightly less than we had expected in 2012, about 3.5%, and banks' balance sheets are now forecast to expand by 1.7% in 2013. Growth in total assets is then projected to rise in subsequent years, picking up pace more significantly in 2015 and 2016 as economic growth accelerates and confidence returns (Chart 1.1).

The Help to Buy scheme outlined in the March budget should help to boost mortgage lending later this year and into 2014. Although only £3.5 billion is allocated to shared equity loans under the scheme, the impact on housing transactions could be more than five times as large, since the government's share of the purchase price is limited to 20%. There is pent-up demand in this sector, as households have been held back by a lack of mortgage finance, so there is potential for an extra £20 billion of home equity loans. As a result, we are increasingly confident that the stock of mortgages will continue to grow. We have raised our forecast of mortgage lending to show a 3% rise this year, up from the increase seen in 2012. We then expect a stronger increase of 3.2% in 2014 and an acceleration to over 4% in 2015-2016 (Chart 1.2).

With banks' loan write-offs having peaked in mid-2012 and provisions against losses falling FLS, which has been extended beyond the major high street banks to finance houses, leasing firms and asset finance groups, should have an increasingly positive impact on lending activity during 2013-14. Despite the current lack of demand for bank lending in the corporate sector, FLS should increasingly help to direct lending to SMEs, for whom credit availability has been much tighter than for large firms, many of which have large cash reserves and do not need to borrow. But there remain a large number of firms being kept afloat mainly by ultra-loose monetary policy and the reluctance of lenders to write off bad loans. As a result non-performing loans (NPLs) overall appear not to have risen as much as in previous recessions. However, the companies being kept afloat are only able to service their debts and cannot invest or expand, so they will continue to weigh on the economy.

We now forecast that loans to businesses will rise by about 3% in 2013, after four years of decline, and then pick up strongly to almost 8.5% in 2014 as current concerns ease and economic growth picks up more noticeably, in turn leading to stronger business investment. However, while this will result in increased lending to consumers and businesses total bank lending is forecast to fall again in 2013 due to a continued decline in lending among financial institutions. This is linked to reduced proprietary trading and other related activities as well as continued rationalisation and cost-cutting. The finding of the Bank of England's Financial Policy Committee in March that UK banks face a £25 billion shortfall in their efforts to rebuild their capital bases (although this was lower than feared), may also prevent a stronger rise in lending. A recovery in total bank lending is forecast in 2014, but it is not expected to return to its 2011 peak until 2015.

Despite the more encouraging signs around credit quality, banks' profitability will remain under pressure because of very weak demand and the effect of low interest rates on margins. These factors are in turn curbing banks' ability to lend to more profitable sectors, and weighing on economic growth. The arrival of the new Governor at the Bank of England in July is expected to herald an even more accommodative monetary policy – perhaps even negative nominal interest rates. Banks' margins will therefore remain under pressure for some time, until inflation falls more significantly later this year and in 2014. Total income at UK banks is now projected to rise by 1.5% in 2013 after an estimated 2% decline in 2012, before recovering more strongly in 2014-15 and then growing by about 5% in 2016 as economic conditions continue to improve (Chart 1.3). But banks' income is not expected to regain its 2010 peak until 2017.

Overall, there is rising optimism about the banking sector. Credit demand is expected to revive gradually in the next two years as the pace of economic growth picks up and deleveraging by companies and consumers continues to ease.

# Banking

**Chart 1.1: UK Banking Sector Total Assets**

Source: ITEM

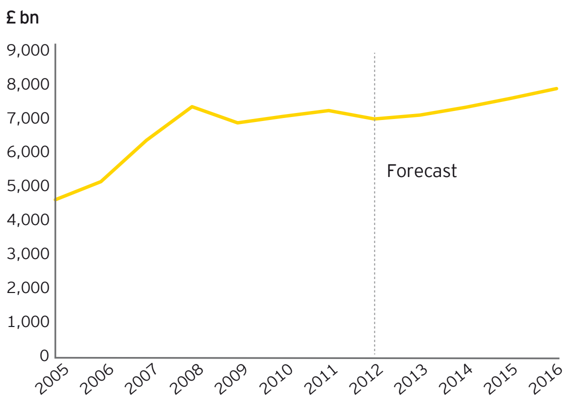



**Chart 1.2: UK Banking Sector Residential Mortgage Loans**

Source: ITEM

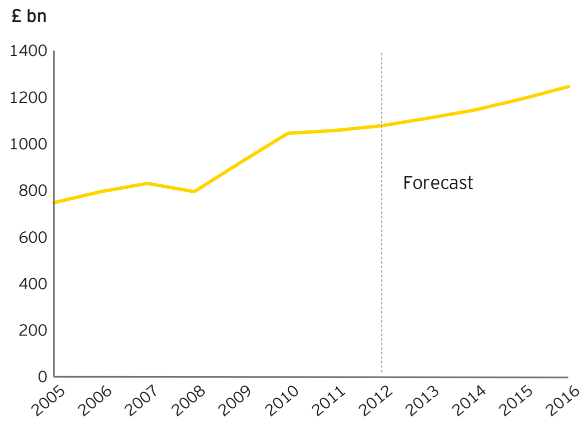
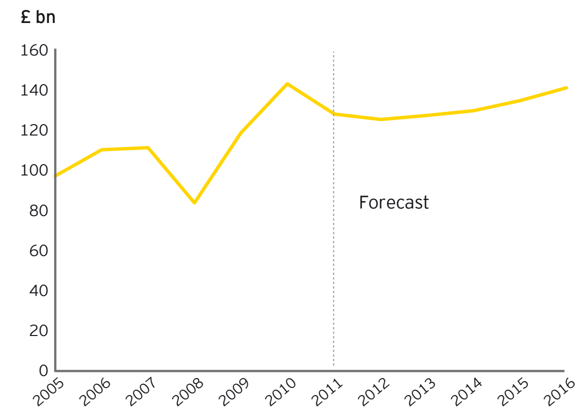



**Chart 1.3 UK Banking Sector Total Income**

Source: ITEM



## Table 2: Banking

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Total assets (£bn)** | 7,230 | 6,983 | 7,102 | 7,320 | 7,583 | 7,872 |
| **Total loans (£bn)** | 6,186 | 5,911 | 5,715 | 5,963 | 6,217 | 6,501 |
| **Consumer credit (£bn)** | 118 | 112 | 108 | 113 | 119 | 126 |
| Write-offs (% loans) | 5.7 | 4.0 | 3.2 | 2.9 | 2.9 | 2.9 |
| **Business/corporate loans (£bn)** | 450 | 427 | 440 | 477 | 534 | 594 |
| Write-offs (% loans) | 1.7 | 1.5 | 1.2 | 1.0 | 0.6 | 0.4 |
| **Residential mortgage loans (£bn)** | 1,056 | 1,077 | 1,109 | 1,144 | 1,192 | 1,244 |
| Write-offs (% loans) | 0.06 | 0.05 | 0.05 | 0.04 | 0.04 | 0.05 |
| **Deposits (% year)** | 2.6 | -5.9 | 2.0 | 6.0 | 6.0 | 6.0 |
| **Loans/deposits (%)** | 128 | 130 | 123 | 121 | 119 | 117 |
| **Total income (£bn)** | 128 | 126 | 127 | 130 | 135 | 141 |

Source: Bank of England/ITEM

## Table 3: Forecast for the UK economy

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Macro variables** | | | | | | |
| Nominal GDP growth (%) | 3.4 | 1.7 | 3.4 | 5.1 | 5.1 | 5.4 |
| Nominal consumption growth (%) | 3.7 | 3.9 | 4.3 | 4.9 | 5.3 | 5.5 |
| Nominal personal disposable income growth (%) | 3.6 | 4.8 | 4.3 | 3.9 | 5.0 | 4.8 |
| Nominal private business investment growth (%) | 3.5 | 5.7 | 1.8 | 9.1 | 11.3 | 9.8 |
| **Financial variables** | | | | | | |
| 3-month interbank rate (%) | 0.9 | 0.8 | 0.5 | 0.5 | 1.0 | 2.0 |
| 10-year gilt yield (%) | 3.1 | 1.9 | 2.0 | 2.6 | 3.6 | 4.2 |

Source: ITEM

# Insurance

The environment remains challenging for UK life insurance businesses due to a combination of slow economic recovery and industry-wide uncertainty around Solvency II requirements. We expect only moderate growth in premium income in 2013 and 2014 after a flat year in 2012 (Chart 2.1). The introduction of RDR and a ban on commissions to reduce 'churn' are already reducing business. Combined with a slowdown in the growth rates of employment and real income, these factors will keep life premium growth negative in real terms in 2013 and limit it to just 1% in nominal terms.

However, we expect premium growth to accelerate to between 4% and 5% in 2015 to 2016, as real employment income growth picks up from 2.6% in 2013 to 5.6% in 2016, and housing market turnover increases by over 30% by 2016 (Chart 2.2). Nevertheless, premium income is still expected to be 20% below its 2007 peak in 2016.

Sales of critical illness and life insurance products stabilised in 2012 as employment rose by 1.7%, prompting an increase in group business. However, further progress will be slower as we expect employment to rise by only 0.7% in 2013 and 1.0% in 2014 (Chart 2.3).

Individual policy sales continue to fall, as the low level of housing market turnover drags down traditional term insurance business. But with the number of property transactions expected to rise by 7.4% in 2013 and 7.8% in 2014, individual policy sales should soon stabilise as well.

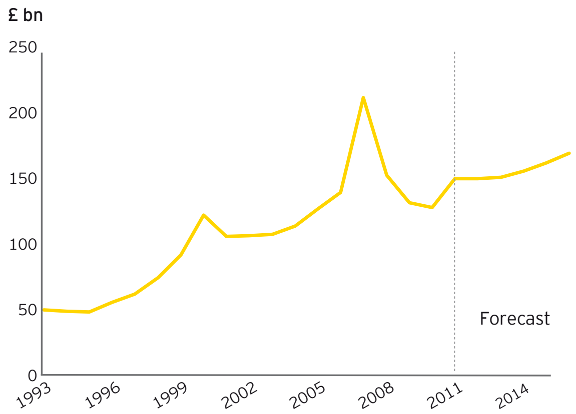
Life insurers have been moving away from traditional guaranteed business, where margins are under pressure and capital requirements are becoming increasingly onerous, by shifting their product mix towards protection and platforms. Nevertheless, they will have to continue to manage their legacy book of guaranteed business. Between now and the end of 2016 we expect 10-year gilt yields to rise from 1.7% to 4.2%. Consequently, guarantees should become easier to meet as portfolio yields improve.

Life insurers are responding to the current challenges by improving investment and asset/liability management, reducing operational costs, adjusting policyholder bonuses and crediting rates, and improving underwriting. Some are also redesigning their business portfolios and undertaking structural changes. Nevertheless, the weakest companies may be forced to stop writing new business or merge with stronger competitors. As a result, industry consolidation is likely to accelerate. Poor profitability will be another driver of consolidation. Insurers' profits declined for a second year running in 2012 and are around 30% below their pre-financial crisis level.

Moderate price increases and improving economic conditions will help non-life insurance premiums to continue to recover. We estimate that non-life insurance premiums grew by 3.1% in 2012. Given the weakness of the economy, most of this growth came from moderate price rises rather than increased exposure. We expect annual premium growth to pick up, averaging 4.3% between 2013 and 2016 as price rises become more widespread. Prices have already started to rise in some non-life insurance segments. The price of health insurance rose by 7.9% in 2012, for example, but the cost of motor insurance fell by 12.5%. A somewhat broader and stronger turnaround in insurance pricing is expected in 2013, as below-cost pricing is unsustainable for any length of time given its negative effect on capital. While Consumer Price Index data shows that private motor insurance prices increased in March, we believe that motor prices will continue to struggle. Many insurers have assumed optimistically that forthcoming legal and regulatory changes will reduce their costs, and are also vying to grow their market share. Their efforts to do this will drive competition and suppress price increases. However, rises are expected in property, corporate and reinsurance rates.

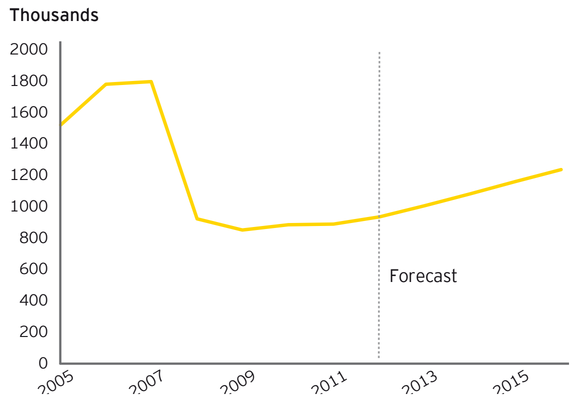
### Chart 2.1: Life insurance premiums

Source: ITEM



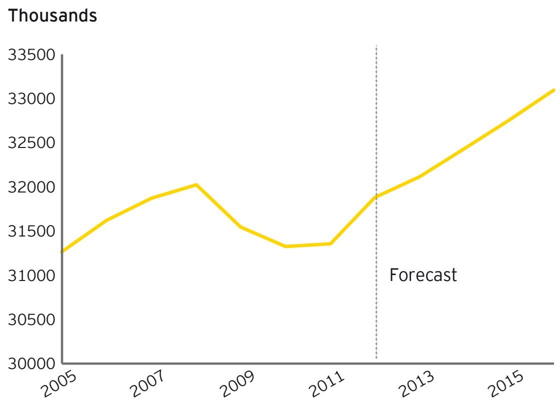

### Chart 2.2 Property Transactions

Source: ITEM




### Chart 2.3 Total Workforce

Source: ITEM




## Table 4: Insurance

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Life gross premium (£bn)** | **149.9** | **149.6** | **151.1** | **155.7** | **161.9** | **169.4** |
| % year | 17.4 | -0.2 | 1.0 | 3.0 | 4.0 | 4.6 |
| **Life gross claims payments (£bn)** | **114.9** | **115.6** | **118.0** | **121.1** | **124.9** | **128.9** |
| Life claims ratio (%) | 77 | 77 | 78 | 78 | 77 | 76 |
| **Non-life gross premium (£bn)** | **58.2** | **60.0** | **63.3** | **66.4** | **68.3** | **71.0** |
| % year | 16.6 | 3.1 | 5.6 | 4.9 | 2.8 | 3.9 |
| **Non-life gross claims payments (£bn)** | **28.5** | **29.3** | **29.9** | **30.5** | **31.1** | **31.8** |
| Paid claims ratio (%) | 49 | 49 | 47 | 46 | 46 | 45 |
| **Net profit (£bn)** | **5.4** | **5.0** | **6.2** | **6.3** | **7.0** | **7.5** |

Source: ITEM

## Table 5: Forecast for the UK economy

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Macro variables** | | | | | | |
| Nominal GDP growth (%) | 3.4 | 1.7 | 3.4 | 5.1 | 5.1 | 5.4 |
| Real GDP growth (%) | 1.0 | 0.3 | 0.6 | 1.9 | 2.5 | 2.5 |
| CPI (% yoy) | 4.5 | 2.8 | 2.8 | 2.6 | 2.6 | 2.5 |
| **Labour market** | | | | | | |
| Total employment (thousands) | 29,166 | 29,519 | 29,896 | 30,210 | 30,536 | 30,871 |
| Employment in manufacturing (thousands) | 2,524 | 2,578 | 2,546 | 2,525 | 2,501 | 2,479 |
| Employment in non-manufacturing (thousands) | 23,444 | 24,188 | 24,385 | 24,716 | 25,089 | 25,467 |
| Unemployment (thousands) | 2,564 | 2,548 | 2,533 | 2,460 | 2,366 | 2,287 |
| **Demographics** | | | | | | |
| Population (thousands) | 62,976 | 63,409 | 63,838 | 64,257 | 64,668 | 65,074 |
| Population of working age (thousands) | 39,165 | 39,432 | 39,706 | 39,974 | 40,233 | 40,478 |
| Population, 65+ (thousands) | 12,070 | 12,140 | 12,185 | 12,210 | 12,223 | 12,229 |
| **Consumers** | | | | | | |
| Nominal personal disposable income (% yoy) | 3.6 | 4.8 | 4.3 | 3.9 | 5.0 | 4.8 |
| Gross household financial wealth (£bn) | 4,298 | 4,439 | 4,743 | 4,828 | 4,883 | 4,982 |
| Personal loans outstanding (£bn) | 105 | 102 | 100 | 104 | 110 | 118 |
| Credit card lending outstanding (£bn) | 56 | 55 | 53 | 52 | 53 | 54 |
| Personal insolvencies (thousands) | 142 | 131 | 117 | 108 | 92 | 77 |
| **Motoring** | | | | | | |
| Car registrations (thousands) | 1,941 | 2,045 | 2,055 | 2,092 | 2,148 | 2,269 |
| **Housing market** | | | | | | |
| House prices (% yoy) | -2.6 | -0.9 | 0.2 | 2.1 | 5.0 | 6.0 |
| Number of households (thousands) | 25,910 | 26,116 | 26,309 | 26,498 | 26,685 | 26,869 |
| Property transactions (thousands) | 884 | 932 | 986 | 1,024 | 1,091 | 1,159 |
| **Mortgage market** | | | | | | |
| Gross mortgage lending (£bn) | 141 | 143 | 160 | 180 | 212 | 248 |
| Net mortgage advances (£bn) | 10 | 8 | 13 | 24 | 42 | 52 |
| Number of mortgages approved | 592,453 | 613,541 | 677,179 | 703,448 | 758,508 | 822,267 |
| Total number of mortgages (thousands) | 11,384 | 11,284 | 11,160 | 11,137 | 11,197 | 11,289 |
| **Corporate sector** | | | | | | |
| New companies (% active companies) | 0.19 | 0.19 | 0.18 | 0.18 | 0.19 | 0.20 |
| Insolvencies (% active companies) | 0.0079 | 0.0072 | 0.0066 | 0.0068 | 0.0070 | 0.0070 |
| Total number of companies | 2,375,315 | 2,531,773 | 2,678,689 | 2,818,447 | 2,972,174 | 3,169,395 |
| Company profits (£bn) | 296 | 291 | 294 | 324 | 347 | 368 |
| **Financial variables** | | | | | | |
| 3-month interbank rate (%) | 0.9 | 0.8 | 0.5 | 0.5 | 1.0 | 2.0 |
| 10-year government bond yields (%) | 3.1 | 1.9 | 2.0 | 2.6 | 3.6 | 4.2 |
| FTSE All-Share (% yoy) | 2.6 | 2.7 | 14.9 | 9.6 | 10.1 | 7.8 |

Source: ITEM

# Asset management

As the global risk environment returns to more normal conditions, we expect investors' behaviour to become more driven by fundamentals, such as valuation, and less by a desire to preserve capital in the face of tail risks. Markets also appear to be more robust to shocks than expected, having taken the Italian elections and the bailout of Cyprus in their stride.

Consequently, we continue to believe that the strongest growth in AUMs will be in 'risk assets' such as equity funds, high-yield debt, multi-asset funds and fund of funds, rather than in defensive asset classes such as government bonds, money market funds or commercial property. Asset managers might want to keep this in mind when formulating their marketing and business plans. This view is supported by industry data showing that in January and February fixed income funds saw their first outflows since October 2008. Overall, we expect AUMs to rise by 10% in 2013 and 7% in 2014 (Chart 3.1).

UK-focused funds saw their AUMs grow by 14% in 2012, in line with the forecast in our last report. The main drivers of this growth were equity and multi-asset funds. The largest contribution to growth came from equities, which account for around half of all AUMs and grew by 13%. Despite representing only 12% of AUMs, multi-asset funds made the second largest contribution as their AUMs grew by 22%. Last year was the fourth consecutive year of strong growth for multi-asset funds, which have benefited from demand from smaller pension funds outsourcing asset allocation as the investment landscape becomes more complicated and the regulatory environment more onerous. If this sector continues to grow at its current pace, it will manage around a fifth of all UK-focused assets by 2016. Even if growth slows (which we expect) as the industry segment matures, the sector will still have grown sufficiently by 2016 to be the second largest fund type after equities (Chart 3.2).

We expect equity funds to be one of the main beneficiaries of risk normalisation, with growth of 10% in 2013 and a further 8% in 2014. Due to their high equity content, fund of funds are also likely to see double-digit AUM growth in 2013 and 2014. However, given investors' increased focus on fees and concerns about standards of due diligence, a return to pre-financial crisis AUM growth rates (which approached 30% a year) seems unlikely. Reduced desire among investors for 'safe havens', coupled with the potential for negative returns, are expected to result in a shift out of gilt-funds, with AUMs declining in 2015 and 2016. We believe that renewed investor confidence will also cause money market AUM growth to slow from 6% in 2012 to around 1% in 2013 and 2014.

The only two fund types to see AUMs fall in 2012 were UK-focused property funds and hedge funds, which experienced small declines of 2% and 1% respectively. We expect capital values for prime property assets to remain firm in 2013 and secondary property values to bottom out over the course of the year. While the polarisation between prime and secondary and between London and the rest of the UK has been a persistent theme since 2009, we do not believe that this trend will continue in the longer term. Property with a secure income is starting to look expensive and it seems likely that good secondary properties will start to outperform prime.

UK-focused hedge funds had a tough first three quarters last year, but performance and AUM growth improved in the final quarter as the risk environment started to normalise. This turnaround has continued into 2013 (Chart 3.3). A more normal risk environment should reduce the 'risk on, risk off' shifts in sentiment and hence the degree of correlation between assets. This should enable funds to maintain positions without triggering risk limits and increase the opportunities for them to invest based on company fundamentals or momentum – two prevalent trading styles. With correlation between stocks lower and dispersion higher, equity long/short managers will be better able to use their skills to identify stock-specific investment opportunities.

**Chart 3.1: Total assets under management**

Source: ITEM/Lipper FMI

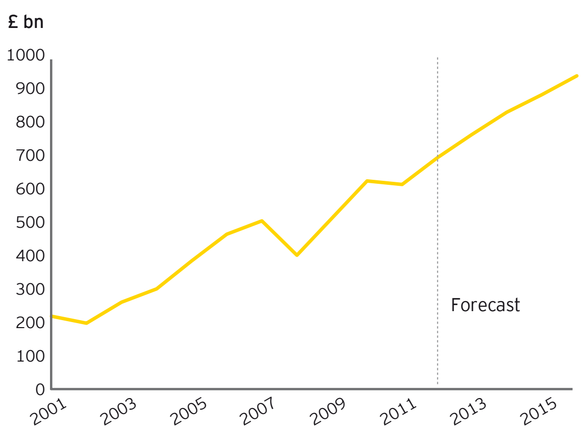
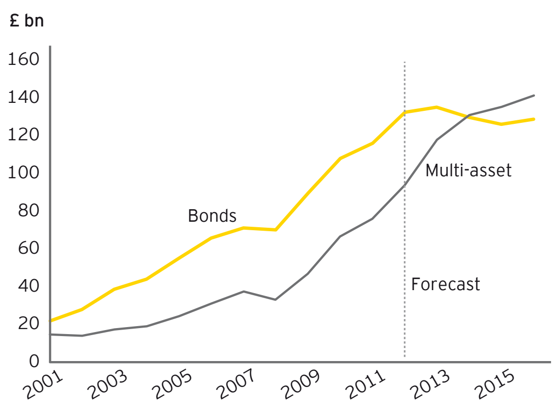


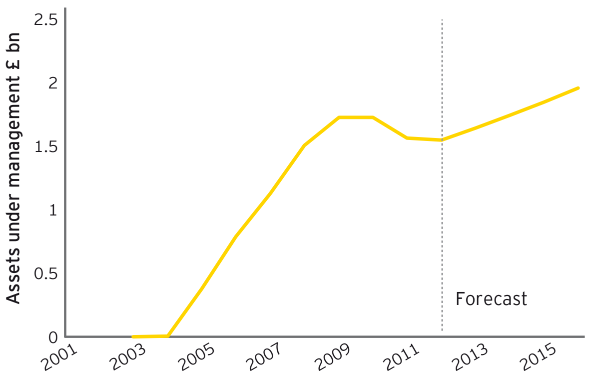

**Chart 3.2: Assets under management**

Source: ITEM/Lipper FMI



### Chart 3.3: UK focused hedge funds

Source: ITEM/Lipper FMI




### Table 6: Asset management

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| Total assets under management (£bn)* | 611 | 698 | 771 | 826 | 873 | 915 |
| % year | -2 | 14 | 10.4 | 7.1 | 5.7 | 4.8 |
| Bonds (£bn) | 116 | 132 | 136 | 136 | 135 | 132 |
| Equity (£bn) | 314 | 356 | 391 | 423 | 456 | 486 |
| Fund of Funds (£bn) | 62 | 72 | 81 | 90 | 100 | 110 |
| Hedge Funds (£bn) | 2 | 2 | 1.6 | 1.7 | 1.8 | 2.0 |
| Mixed (£bn) | 76 | 93 | 117 | 130 | 134 | 137 |
| Money Market (£bn) | 27 | 28 | 29 | 29 | 29 | 30 |
| Property (£bn) | 16 | 16 | 16 | 17 | 17 | 19 |

*UCITS and non-UCITS assets

Source: ITEM; Lipper FMI

### Table 7: Forecast for the UK economy

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Macro variables** | | | | | | |
| Nominal GDP growth (%) | 3.4 | 1.7 | 3.4 | 5.1 | 5.1 | 5.4 |
| Real GDP growth (%) | 1.0 | 0.3 | 0.6 | 1.9 | 2.5 | 2.5 |
| CPI (%) | 4.5 | 2.8 | 2.8 | 2.6 | 2.6 | 2.5 |
| **Financial variables** | | | | | | |
| 3-month interbank rate (%) | 0.9 | 0.8 | 0.5 | 0.5 | 1.0 | 2.0 |
| 10-year government bond yield (%) | 3.1 | 1.9 | 2.0 | 2.6 | 3.6 | 4.2 |
| FTSE All-Share (% yoy) | 2.6 | 2.7 | 14.9 | 9.6 | 10.1 | 7.8 |
| **Households** | | | | | | |
| Wealth (£bn) | 4,298 | 4,439 | 4,743 | 4,828 | 4,883 | 4,982 |
| Savings flow (£bn) | 68 | 78 | 84 | 77 | 77 | 73 |

Source: ITEM


FTSE
EUROS
50
£500
£000
POUNDS
¥9134
¥600
1234
5678
910
increase
forty five cents
25
YEARS
index
roubles
Rs %
RUPEE
YEN
ftse 100
40
FORTY

# More information

## Ernst & Young ITEM Club publications

Ernst & Young ITEM Club Economic Forecast is a macro-economic report that uses the HM Treasury model to provide an outlook for the UK economy and key business implications.

**Scotland Forecast** is a bi-annual extension of the UK forecast and the **Ireland Forecast**, the bi-annual *Economic Eye,* is the only forecast that covers both north and south Ireland together.

ey.com/uk/economics

## Ernst & Young Eurozone Forecast

The quarterly forecast provides an overview of developments across the Eurozone and the 17 individual member states. It uses the ECB model and governmental statistics to offer insight into the issues that affect the region's governments and businesses.

**Outlook for financial services**. A comprehensive quarterly forecast for the regions banks, asset managers, and insurers based on the ECB model and governmental statistics.

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## Global Capital Confidence Barometer

The barometer is a regular survey of senior executives from large companies around the world, conducted by the Economist Intelligence Unit. Our findings gauge corporate confidence in the economic outlook, and identifies boardroom trends and practices in the way companies mange their capital agenda.

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